

State Board of Equalization

OPERATIONS MEMO

For Public Release

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SUBJECT: Partial Exemption for Manufacturing and Research & Development Equipment

I. OVERVIEW

This Operations Memo provides guidelines and procedures for the implementation of Revenue and Taxation Code (RTC) section 6377.1, and pending Regulation 1525.4, Manufacturing and Research & Development Equipment. RTC section 6377.1 provides a partial exemption from sales and use tax on qualifying sales and purchases of equipment used in manufacturing or research and development. The partial exemption applies to qualifying sales and purchases made on or after July 1, 2014, and before July 1, 2022.

The new partial tax exemption in RTC section 6377.1 is similar to the prior partial exemption in that the exemption applies to qualifying tangible personal property purchased for use by a qualified person. However, there are significant differences between the old and new partial exemption.

1. The definition of a qualified person has been changed to include businesses primarily engaged in research and development activities, as described in certain North American Industry Classification System (NAICS) codes,¹ whereas the prior definition of qualified person only included businesses engaged in manufacturing activities. The new partial tax exemption excludes certain trades or businesses that are currently required to, or would be required to apportion their income pursuant to subdivision (b) of RTC section 25128, if subject to apportionment pursuant to specified sections of California's Corporation Tax Law (RTC div. 2, pt. 11, § 25101, et. seq.)
2. RTC 6377.1 now includes a requirement that the qualified person be "primarily engaged" in a qualifying manufacturing or research and development activity.
3. The partial exemption is no longer limited to a new trade or business.
4. The new partial exemption applies to certain qualifying purchases by a construction contractor, purchasing that property for use in the performance of a construction contract for a qualified person.

These differences generally increase the number of taxpayers that may be eligible to take advantage of this partial exemption.

¹ As published by the United States Office of Management and Budget, 2012 edition.

From July 1, 2014 through June 30, 2022, this legislation provides manufacturers, biotechnology and other physical, engineering, and life science researcher and developers, as classified under NAICS Codes 3111 to 3399, inclusive, 541711, or 541712, a partial sales and use tax exemption for their purchases of qualifying tangible personal property to be used primarily in manufacturing or research and development activities. This legislation limits the allowable exemption to \$200 million in qualifying purchases each calendar year for each qualified person. It also provides that the aggregate of all purchases for which an exemption is claimed by all qualified persons required or authorized to be included in a combined report under California's Corporation Tax Law² cannot exceed \$200 million in qualifying purchases during any calendar year.

Qualifying transactions subject to the partial exemption are exempt from the state general fund taxes imposed by RTC sections 6051, 6051.3, 6201, and 6201.3, and the State's Education Protection Account tax imposed by Section 36, Article XIII of the State Constitution. Accordingly, from July 1, 2014, to December 31, 2016, the partial exemption rate is 4.1875 percent. After the State's Education Protection Account tax expires on December 31, 2016, the partial exemption rate will be 3.9375 percent.

Retailers

Retailers are required to obtain a timely partial exemption certificate from the purchaser to support a deduction for equipment used in manufacturing or research and development. The retailer must obtain and retain in its records a partial exemption certificate from the purchaser; otherwise, the partial exemption will not be allowed.

A seller will be presumed to have taken a partial exemption certificate in good faith in the absence of evidence to the contrary.

Purchasers and Partial Exemption Certificates

Qualified persons who purchase equipment to be used in manufacturing or research and development must issue a partial exemption certificate to the retailer in order for the retailer to claim the partial exemption. The purchaser may use form [BOE-230-M](#), *Partial Exemption Certificate for Manufacturing and Research & Development Equipment* found in Appendix A of Regulation 1525.4.

If a taxpayer does not know their NAICS code they can get help at the [United States Census Bureau](#) website where they can search for codes, or email the Census Bureau directly with specific questions.

Construction Contractors

Construction contractors who purchase qualified tangible personal property for use in the performance of a construction contract for a qualified person, who will use that property in a qualifying manner, must issue a partial exemption certificate to the retailer in order for the retailer to claim the partial exemption. The construction contractor may use form [BOE-230-MC](#), *Construction Contracts- Partial Exemption Certificate for Manufacturing*

² RTC Division 2, Part 11 (section 25101, et. seq.)

and Research & Development Equipment found in Appendix B of Regulation 1525.4. If materials purchased under an exemption certificate are found to be used for a non-qualifying contract, the construction contractor will be liable for the tax.

When performing qualifying construction contracts for qualified persons, construction contractors should obtain a BOE-230-M partial exemption certificate from the qualified person. If a construction contractor takes a certificate in good faith from a qualified person, and the qualifying person is later found to not qualify for the partial exemption, the qualifying person who issued that certificate will be liable for the payment of tax.

A contractor that is also a qualified person may issue a BOE-230-M partial exemption certificate to their retailer and purchase qualified tangible personal property subject to the partial exemption, provided all other requirements are met.

Both of these partial exemption certificate forms are available for download on the BOE's website. Issuance of a partial exemption certificate certifies in writing that the tangible personal property purchased will be used in a manner entitling the seller to regard the gross receipts from the sale as partially exempt from the sales tax. Purchasers are responsible for tracking their purchases to ensure they do not exceed the \$200 million annual cap. If a purchaser exceeds the \$200 million limitation, or if within one year from the date of purchase, removes the property from California, converts the property for use in a manner not qualifying for the exemption, or uses that property in a manner not qualifying for the exemption, the purchaser is liable for payment of the sales tax, with applicable interest as if the purchaser was a retailer making a retail sale.

II. REVISIONS TO SALES AND USE TAX RETURNS

Sales and use tax returns and instructions have been updated to include lines for the manufacturer's exemption.

Electronic Filing

On the exemption screen, a Partial State Tax Exemption on Manufacturing and Research and Development Equipment section was added. This section will calculate the partial exemption, making adjustments for items such as bad debts, cash discounts, and returned taxable merchandise which will be entered on the deductions screen.

On the deduction screen, under the deductions for Bad Debt Losses on Taxable Sales, Returned Taxable Merchandise, and Cash Discounts on Taxable Sales, a question was added asking if any of these claimed deductions were on manufacturing and research and development equipment. When a taxpayer selects the "yes" radio button, a field appears where they can enter the amount of these deductions related to manufacturing equipment sales. These entries will carry over to the exemption page to net out the total exemption available.

A new line was added under the exemption category on the review filing, confirm filing, and filing history pages. The reprint utility page was modified to add a section titled,

“Manufacturing and Research and Development Equipment Exemption on or after 7/1/2014”.

III. SYSTEM CHANGES

Changes were made to the REV RD screen in IRIS. A static line was added to the bottom of the screen that says “Partial State Tax Exempt Manufacturing” below the line that says “Partial State Tax Exemption MVF.” In the description section, the “Manufacturer’s Exemption” line was removed. This line was from the prior manufacturer’s exemption. A new line was added to the end of the list of deductions that says “Manufacturing Exemption.” There are now three screens to scroll through in REV RD.

IV. AUDITS

This partial exemption is the first partial exemption that has an annual cap, limiting the amount of purchases subject to the partial exemption that can be claimed in a calendar year to \$200 million per qualified person. Audit staff will be responsible for verifying that qualified purchasers, those described in NAICS codes 3111 to 3399, 541711, and 541712, have not exceeded the \$200 million cap.

A. Audit Procedures

Retailers. Audit staff should verify that partial exemption certificates have been obtained for all claimed partial exemptions. General ledger sales to customers in California should be examined and reviewed on an actual basis to identify taxpayers making significant purchases. If the retailer has significant sales to one individual taxpayer that the auditor believes may cause the purchaser to exceed the annual purchase limit, a BOE-1164, *Audit Memorandum of Possible Tax Liability* should be sent to the district of the purchaser.

Qualified persons. The person will not be precluded from qualifying when there is no applicable six digit NAICS code to describe their line of business, provided that their business activities are reasonably described in a qualified four digit industry group. For example, a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are reasonably described in a qualified four digit industry group.

Purchasers. Audit staff should review capital asset purchases and verify tax rates paid on purchases. When incorrect tax rates are found, further review of transactions should be done on an actual basis. Follow standard audit procedures to pick up differences or have the taxpayer file a claim for refund where necessary. See the example below for how to indicate differences in the Juris Grid.

B. Preparing Audits for Uploads

1. Start 21 Program – BOE Audit Program

- a) The noncompliance code template (414N Code tab) includes three new noncompliance codes:

- 3001 - Exemption Not Claimed
- 3002 – Exemption Over Claimed
- 3003 – Exemption Under Claimed

b) The Juris Grid was updated to add fund code 904 to the grid. Displayed below are some possible audit scenarios you may encounter, demonstrating the proper way to indicate the error in the linking worksheet.

| R | C | A | B | C | D | E | F | G | H | I | J | K |
|-----|---|---|---------|-----------|---------------|---------------|---------------|---------------|---------|---------|-------|------------|
| REF | | JURISDICTION (FUND CODE) | STATE | LRF (904) | ASUT (057) | LPSF (056) | SLRF (055) | SCHL (908) | LOCAL | COUNTY | STJ | Total Rate |
| 1 | | Full Rate | 4.7500% | | 0.2500% | 0.5000% | 0.5000% | 0.2500% | 1.0000% | 0.2500% | | 7.5000% |
| 2 | | Partial Rate Exempt | 4.7500% | -1.0625% | 0.2500% | | | 0.2500% | | | | 4.1875% |
| | | Partial Rate Taxable | | 1.0625% | | 0.5000% | 0.5000% | | 1.0000% | 0.2500% | | 3.3125% |
| 3 | | AUDIT SCENARIOS | | | | | | | | | | |
| 4 | | ONE ERROR IN AUDIT | | | | | | | | | | |
| 5 | | Sale subject to partial exemption not reported & included in audit | | 1,000 | | 1,000 | 1,000 | | 1,000 | 1,000 | 1,000 | |
| 6 | | Sale subject to partial exemption not claimed; credit allowed | -1,000 | 1,000 | -1,000 | | | -1,000 | | | | |
| 7 | | Partial exemption disallowed | 1,000 | -1,000 | 1,000 | | | 1,000 | | | | |
| 8 | | | | | | | | | | | | |
| 9 | | MULTIPLE ERRORS IN AUDIT | | | | | | | | | | |
| 10 | | Unreported ex-tax purchases | 1,000 | | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | |
| 11 | | Sale subject to partial exemption not reported & included in audit | | 1,000 | | 1,000 | 1,000 | | 1,000 | 1,000 | 1,000 | |

V. RETURN ANALYSIS AND LOCAL REVENUE ALLOCATION UNITS

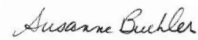
Qualified persons cannot claim more than \$200 million in qualifying purchases subject to the partial exemption each calendar year. Persons may make purchases and issue partial exemption certificates with the intention of qualifying for the partial exemption in the one year period following the date of purchase. If a purchaser issues a partial exemption certificate to the seller and later discovers that they exceeded the annual cap or the purchase otherwise does not qualify for the partial exemption, the purchaser is responsible to report and pay the sales or use tax amount, with applicable interest directly to the BOE.

To report the tax difference, the taxpayer will have to amend their sales and use tax return in the period the purchase was made by entering a negative deduction in the partial manufacturing exemption section. If the taxpayer does not hold a seller's permit, they

will have to register to report and pay the tax difference. Form BOE-79B, *California Use Tax-For Purchase Made from Out-of-State Businesses* cannot be used to report the partial exemption. These payments will create a return edit and the allocation to the proper accounts will have to be done by the Return Analysis and the Local Revenue Allocation Units.

VI. OBSOLESCENCE

This operations memorandum will become obsolete when the information contained herein is incorporated into chapter four of the audit manual.



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